STRENGTHENING THE EQUALIZATION PROGRAM

Perspective of the Finance Ministers of the Provinces and Territories[1]

September 2003

[1] Given the election in Ontario, this province could not participate in the preparation of this Finance Ministers' document. Accordingly, it does not reflect in any way the views of that province.

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1. INTRODUCTION

The Equalization Program is an essential component of fiscal arrangements in Canada and needs to be strengthened to fulfil its Constitutional mandate. The current program must be renewed on April 1st, 2004, and Finance Ministers are meeting in the coming months to conclude the renewal discussions. Consequently, provinces and territories regard it important to present to the federal government their common perspective on strengthening the Program at this time.

The growing fiscal imbalance between the federal government and the provinces and territories raises concerns over the adequacy of fiscal arrangements between the orders of government. Provinces and territories have expressed their need for improved funding for health and social services on many occasions, even after last February's federal announcement. It should be noted that some provinces have individual views on different mechanisms to adjust disparities, such as the removal of tax points from CHST or a new sharing of the tax room between the two orders of government. However this report focuses attention on the adequacy of the Equalization program in levelling fiscal imbalances among provinces.

By bridging part of the disparities in the capacity to raise revenue among the provinces, the Equalization Program enables all regions to offer more comparable levels of public services and narrows the differences in tax burdens for Canadians across the country.

The importance of Equalization has been acknowledged by its entrenchment in the Constitution. Section 36(2) of the *Constitution Act, 1982* stipulates that:

> "Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."

In its current structure, the Equalization Program is becoming more and more inadequate in its ability to achieve this constitutional commitment. Since the beginning of the 90s, Equalization entitlements have been declining as a proportion of GDP while fiscal disparities in Canada have not been significantly reduced. A majority of Premiers and Finance Ministers of the provinces and territories have pointed out on many occasions over the last two decades the need to enhance the adequacy of the Equalization Program. A recurring pattern of large unforeseeable changes to

Equalization entitlements also has led to increasing concern with improving stability and predictability.

In the wake of these repeated calls and with the approach of intensive discussions in the fall that will lead to the adoption of changes to the Program starting April 1, 2004, provincial Finance Ministers have jointly identified proposals to strengthen the Equalization Program. Possible approaches include:

- a ten-province standard that recognizes the volatility around resource revenues; and,
- the full inclusion of all provincial revenues in the calculation of Equalization entitlements, in particular revenue from user fees.

As well, provinces are concerned with the destabilizing effect on provincial finances of substantial and unpredictable fluctuations in Equalization revenues, caused by data shocks and methodological changes to tax bases that often have multi-year impacts. Provinces and territories would like to consider remedial measures in consultation with the federal government that also reflect the principles of adequacy, accuracy and responsiveness to changing fiscal circumstances.

An example of a destabilizing influence is the revision of population figures this September to embody the 2001 Census, which will have significant impacts on transfer payments to provinces and territories. While the exact impacts are not yet known, it is evident that some provinces and territories could face very large negative adjustments. In the absence of mitigating measures, the timing of the release of data, combined with the unknown effects of the data itself, will require some provinces and territories to react to potentially large negative impacts well into their fiscal year. As a result, Finance Ministers call on the federal government to forgive census related losses, as well as provide fair and meaningful relief to provinces and territories that face dramatic data shocks and methodological changes to tax bases that negatively affect their transfer revenues from the Federal Government.

Action is required to strengthen the Equalization Program and reverse the trend of growing inadequacy of the Program. All provinces agree on possible approaches to improve the major parameters of the Program. Furthermore, individual provinces also have specific concerns as to the definition of certain tax bases[2]. However, these specific concerns will be presented by each province to the federal government.

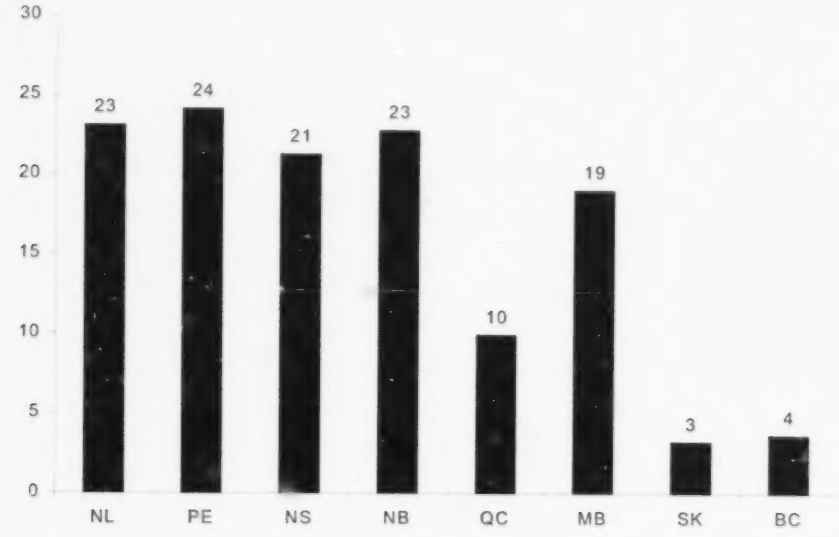
[2] British Columbia has very serious concerns about the possible adoption of a market value-based approach for the property tax base, which it fundamentally does not believe is the correct measure of relative provincial fiscal capacity, and which would result in British Columbia being ineligible for Equalization now and in the foreseeable future. However, Quebec and other provinces have asked the federal government numerous times to use assessed market values to measure fiscal capacity for the property tax base. For these provinces, a market-value approach would greatly improve the internal consistency of the Program and put an end to decades of under-compensation to recipient provinces.

2. STRENGTHENING THE EQUALIZATION PROGRAM

In 2002-2003, the federal government paid Equalization transfers totalling $10.9 billion to eight of the ten provinces. These transfers are unconditional, so the provinces can use them as they see fit. In addition, Equalization transfers have an important role in helping many provinces fund their public services without raising tax rates.

Equalization revenue is a major portion of provincial budgets for many provinces. It accounts for almost one-quarter of the budgetary revenue of the Atlantic provinces and close to 10% for Québec.

Chart 1
Equalization as a proportion of provincial budgetary revenue, 2002-2003
(Per cent)



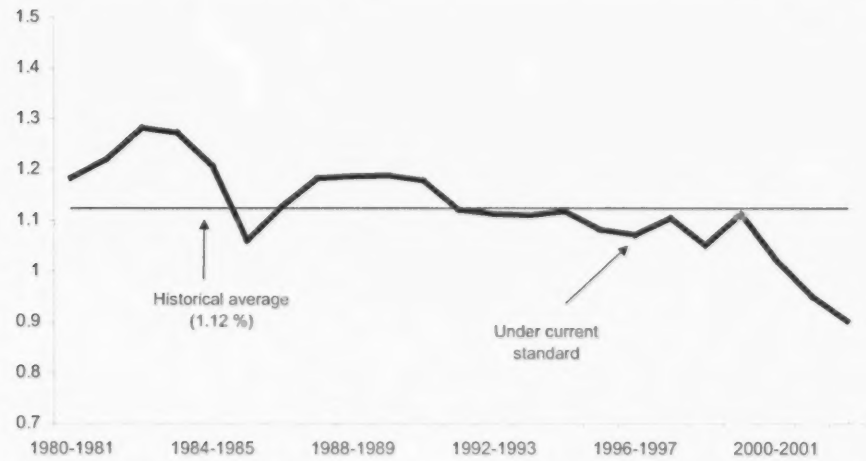
Sources: Department of Finance Canada; provincial Budgets.

In view of its importance, federal and provincial officials examine the Equalization Program on an ongoing basis. Every five years, this examination gives rise to amendments by the federal government to the legislation and regulations governing the program, commonly referred to as the "Equalization Renewal".

As part of the current renewal, which must be completed before April 1, 2004, officials are studying a number of technical changes intended to ensure that the Equalization Program accurately measures the relative fiscal capacity of the provinces. All provinces agree on possible approaches to improve the major parameters of the Program such as the standard and comprehensive revenue coverage. They also are concerned with the need for improved predictability and stability, but not at the expense of the Program's adequacy. Furthermore, individual provinces also have specific concerns as to the definition of certain tax bases. This document focuses on the major parameters of the Program and as such, does not deal with all the specific tax bases and proposed solutions.

Provinces believe that the federal government has the fiscal flexibility to strengthen the Equalization Program. Since 1997-1998 alone, the federal government has achieved a cumulative $60 billion surplus. In addition, as a proportion of Canada's GDP, the cost of Equalization has been declining since 1982.

Chart 2
Equalization entitlements in Canada as a proportion of GDP under the current standard, 1980-1981 to 2002-2003
(Per cent)



Sources : Department of Finance Canada; Statistics Canada; public accounts of the provinces and the federal government.

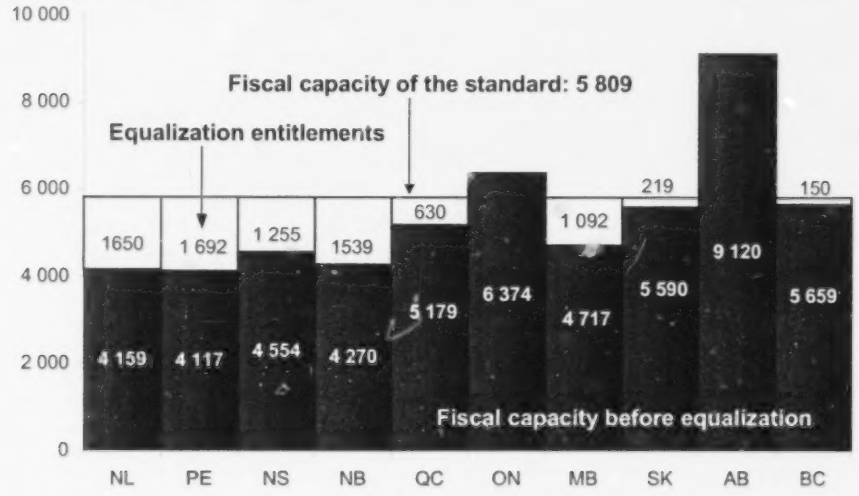
Accordingly, the issue is more one of priorities than of financial capacity. The federal government has the financial resources to allow all provinces to deliver comparable services at a comparable level of taxation, but the formula in place has become increasingly inadequate.

2.1 Replace the current standard with the ten-province standard

The standard is a basic parameter of the Equalization Program. Indeed, the fiscal capacity of each province is compared to that of the standard to establish its revenue-raising ability relative to the standard. Only those provinces whose fiscal capacity is lower than that of the standard are entitled to receive Equalization payments. Since 1982, the standard represents the fiscal capacity of only five provinces : Québec, Ontario, Manitoba, Saskatchewan and British Columbia. This list excludes the province with the highest fiscal capacity (Alberta) and the four provinces with the lowest fiscal capacity (the Atlantic provinces).

Overall, after Equalization, the fiscal capacity of the recipient provinces is raised to the average of the five provinces that make up the standard, equivalent to $5 809 per capita in 2002-2003.

Chart 3
Equalization entitlements, 2002-2003
(Dollars per capita)



Source : Third estimate of entitlements for 2002-2003, Department of Finance Canada.

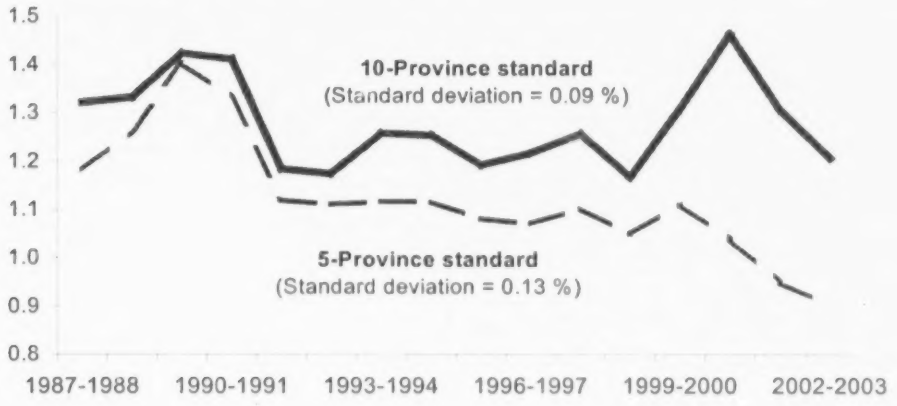
Replacement of the current standard with one representing the fiscal capacity of all ten provinces would make an appreciable improvement to the Program. By taking the fiscal capacity of all the provinces into account, a better measure of the disparities within the Canadian federation would be obtained and, consequently, the level of entitlements would serve to better achieve the constitutional objective. Currently, Equalization receiving provinces are raised to 96.4 % of the national average fiscal

capacity, this means that the recipient provinces have $218 less per capita than the average of the ten provinces to deliver public services in their fields of jurisdiction, i.e. a shortfall of more than $3.5 billion in 2002-2003. In addition, using the ten-province standard would result in more consistent and comprehensive coverage of provincial sources of revenue. At present, only 20% of fiscal capacity in the field of oil and gas resources in Canada is subject to Equalization since a significant share of these resources are located in provinces that are not included in the standard. On the other hand, 95% of fiscal capacity for hydroelectric power, another source of energy, is included in the standard. The adoption of a ten-province standard would remove this existing bias in the measurement of fiscal capacity.

The federal government has so far raised two main arguments against the ten-province standard. First, adopting this standard would increase the volatility of revenue to the provinces considerably because by including all natural resources, it would expose all provinces to the substantial fluctuations in energy prices. Second, the cost of the Program would be appreciably higher if this standard was to be adopted, exerting unacceptable pressure on the federal financial framework. These two arguments do not stand up to scrutiny.

With respect to Program volatility, the following chart shows that if a ten-province standard had been retained, the Program would not have been more volatile on the whole than with the five-province standard. Furthermore, the volatility of Equalization revenue is a special problem that federal, provincial and territorial Finance Ministers could solve. Therefore, Finance Ministers agree that one possible way to strengthen the program is a ten-province standard that recognizes the volatility around resource revenues. As for the federal ability-to-pay issue, as indicated above, provinces believe that the federal government has enough fiscal flexibility on an ongoing basis to strengthen the Equalization Program.

Chart 4
Equalization standards, 1987-1988 to 2002-2003
(as a percentage of GDP)



Source : Manitoba Finance.

The proposal to restore the ten-province standard is supported by many people, including the members of the Standing Senate Committee on National Finance who ruled in March 2002 in their report "The Effectiveness of and Possible Improvements to the Present Equalization Policy":

> "(...) we recommend (...) a return to a ten-province standard in calculating revenue capacity, and therefore Equalization entitlements of provinces. Although these changes will enrich the Equalization Program, the increases — while significant for the recipient provinces — are in our opinion affordable for the federal treasury and appropriate for a program that is one of the pillars of Canadian federalism. (...) a five-province standard does not fulfil the intent of the program, which is to provide adequate funding that allows the provinces to provide comparable services to their residents. Stability in the level of Equalization payments is desirable but it should not come at the expense of adequacy in the level of payments."

2.2 Include all revenue in the calculation of Equalization

Since the 1999 renewal, the Equalization formula includes only 50% of revenue from the sale of goods and services, sometimes called user fees. This measure is reducing Equalization entitlements by around $500 million in 2003-2004 alone. In support of its decision, the federal government stated that government sales of goods and services are commercial transactions and substitute for the private sector. It also maintained that these transactions generate no fiscal capacity for provincial governments since the cost for taxpayers is equivalent to the value of services received.

The Finance Ministers of the provinces and territories are of the view that these arguments are groundless. Sales of goods and services generally do not correspond to commercial activities, even though in some cases the private sector may be involved in the delivery of services. The services in question (public transit, public health, water management, heritage conservation, etc.) are essential to public well-being and likely could not exist in their current widely accessible form if they were not delivered or regulated and subsidised by the State.

- Revenues from the sale of goods and services are often substitutes for general taxes. Most often they are compulsory charges that are not directly linked to the level of consumption of services (e.g.: taxes on the number of feet of frontage of houses for water supply, sewers, etc.). The compulsory nature of these charges is similar to direct taxation.

- In many cases, revenues from the sale of goods and services go into consolidated revenues which are used to fund all public services, as opposed to being earmarked for the delivery of those goods and services.

- As is the case with taxes, the more-affluent provinces can provide more and better quality services and/or collect more revenue from sales of goods and services than the less-affluent provinces. Excluding these revenues from the Equalization Program means that, the less-affluent provinces cannot afford the same quality of service as the other provinces.

- Excluding these revenues from Equalization creates discrimination on the basis of the method of funding used by the provinces. Accordingly, funding of a public service is subject to Equalization in the case of taxes but is partially excluded in the case of user fees. This could distort provincial policy decisions, which the Program is not intended to do.

The Finance Ministers of the provinces and territories also point out that a significant share of revenues from the sale of goods and services and from user fees was not subject to Equalization even before the 50% reduction imposed in 1999. The various fees collected by universities and colleges (including tuition fees), housing corporations and health and social services institutions are not equalized. Of the $28.7 billion of revenue arising from the sale of goods and services in 1999-2000, only $8 billion was subject to Equalization.

Table 1
Sales of goods and services in Canada, 1999-2000
(Billions of dollars)

Category	Revenue from sales	Revenue subject to Equalization
Provincial governments		
Provincial administrations		
Fees, other than housing corporations	5.2	2.6
Housing corporations	0.6	0.0
Universities and colleges	6.7	0.0
Health and social services institutions	5.5	0.0
Subtotal	**18.0**	**2.6**
Local governments		
Municipal administrations		
Water, sewage and garbage	4.8	2.4
Other services	5.1	2.6
School boards	0.8	0.4
Subtotal	**10.7**	**5.4**
Total	**28.7**	**8.0**

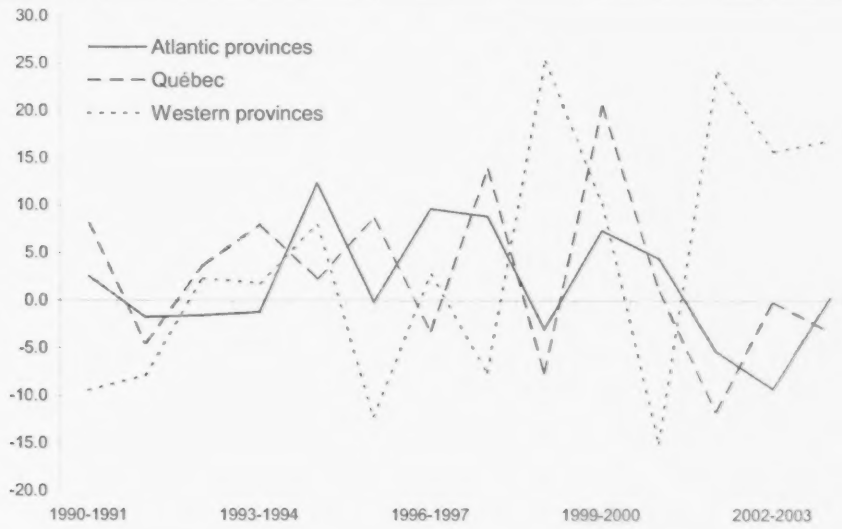
Note : Sales from one public administration to another are excluded.
Sources : Department of Finance Canada; Statistics Canada.

In this context, the Finance Ministers of the provinces and territories are of the view that as part of this renewal, all revenue from sales of goods and services and user fees excluded from the Program in 1999 should be reintegrated into the calculation of Equalization entitlements. In addition, they believe that in future, work should continue to determine whether revenues from user fees collected in particular by hospitals and universities should be subject to Equalization to ensure complete coverage of provincial revenues for Equalization purposes.

3. IMPROVE THE PREDICTABILITY AND STABILITY OF EQUALIZATION ENTITLEMENTS

Equalization is a major source of revenue for many provinces, in some cases representing almost one quarter of a province's total revenue. In recent years, Equalization revenue have fluctuated significantly from year to year in some provinces. As the following chart shows, this volatility can result in a drop in entitlements of 15% for a given year followed by an increase of almost 25% the year after. Also, considering that only the last available estimate of entitlements since 1990-1991 is used in the chart, it does not fully reflect certain factors likely to exacerbate fluctuations such as the lack of precision of the initial estimates and the mechanics of payment.

Chart 5
Volatility of Equalization entitlements, 1990-1991 to 2003-2004
(Per cent)



Source . Department of Finance Canada.

Major fluctuations in Equalization revenue often have harmful consequences for provincial budgetary planning and for the delivery of public services. Indeed, provinces are often informed of significant fluctuations in their revenue at the very end of the fiscal year. These large fluctuations in Equalization revenue reflect a number of factors:

- The use of unproven data sources and methodologies and major changes to the methods and concepts used to define the data for calculating entitlements between renewals have resulted in unexpected and significant changes in Equalization. For instance, the new mining tax base (and associated data update), the changes made in February 2002 to the measurement of the stock of residential capital used to calculate the property tax base and the correction of the CCRA's error in the personal income tax base formula resulted in significant shortfalls for some provinces.

- Equalization entitlements are very sensitive to changes in certain economic variables, population data in particular. Every five years, population estimates are subject to major revisions as a consequence of the Census of Population. These revisions often have a very substantial impact on Equalization revenue. Preliminary information from Statistics Canada concerning these revisions shows that the 2001 Census will have a large impact on provincial revenues. Given its impact on four years open to adjustment, the overall loss to Equalization receiving provinces is expected to be around $1 billion.

- Because its structure is based on the economic performance and the fiscal parameters of each province, the Equalization Program naturally generates significant variability in revenue.

- Lastly, these factors are accentuated by the fact that Equalization revenue for a given year includes not only the estimate for the current year but also revisions to the estimates for the preceding three years. The impact of revisions to data is often amplified by this mechanism.

While the first and foremost pursued objective of the Finance Ministers of the provinces and territories in this renewal is to bolster the adequacy of the Equalization Program, they also believe that changes could be made to reduce the volatility of Equalization revenue after appropriate consultation with provinces. Provinces oppose any changes, however, that do not respect the following principles:

- significantly reduce the volatility of the Program for the provinces and the federal government without compromising the adequacy and accuracy of entitlements for any province;

- ensure a fair and meaningful relief to provinces that face dramatic shocks between renewals that negatively affect their Equalization revenue, such as the impact of the census, and also from changes to tax bases resulting from the Renewal Process, while providing equitable treatment to the other provinces;

- do not reduce the program's responsiveness to changes in the relative economic situations of provinces.

Finally, it should be mentioned that the effort to implement those principles would be compromised if the quality and availability of data used for the entitlements calculations are not improved. Statistics Canada should be provided with adequate resources to pursue this objective.

4. STRONGER PARTNERSHIP BETWEEN THE FEDERAL GOVERNMENT AND THE PROVINCES

The ability to obtain relatively comparable public services, regardless of province of residence, is a value Canadians cherish. The Equalization Program puts this value into practice by reducing disparities in fiscal capacity between provinces that, in particular, are responsible for public health, education and social assistance services in Canada. An adequate Equalization Program makes a real difference in the lives of Canadians.

While officials have held many meetings to consider the technical aspects of the Equalization Program, the broad orientations of the Program and its role in building a more competitive and fiscally balanced Canada have not been discussed sufficiently by Finance Ministers on the occasion of recent renewals, despite repeated requests from the provinces. As a result, there is a lack of a common vision on ways of promoting equal opportunities for the well-being of Canadians and furthering economic development in every region of the country.

In this regard, at their meeting in July 2003, the Premiers were disappointed that so little progress on strengthening the Program has been made in the current round of Equalization Renewal. Premiers are in full agreement that the federal government must work in true partnership with provinces and territories to address the disparities that exist among provinces, a partnership that involves more effective consultations between equal partners on key programs such as Equalization. As such, Premiers agreed that it is critical for their Finance Ministers to have meaningful discussions with the federal minister before the federal proposals are finalized. The opportunity exists now to provide a meaningful strengthening of the Equalization Program.

5. CONCLUSION

These Finance ministers' perspectives have been presented in a constructive spirit with the objective to improve an important program for Canadians. Those proposals would also reverse the trend of growing inadequacy of the Equalization Program. Finance ministers look forward to the coming federal-provincial meetings on Equalization renewal to have serious discussions with the federal government on these proposals.